HANDOUT 1
REPORTING SPECIAL CATEGORIES

The specialized accounting and financial reporting used for governmental funds remain the most unique features of the governmental financial reporting model. Indeed, most of the specialized categories established for financial reporting by state and local governments involve governmental funds.

Other financing sources

Governmental funds focus on inflows and outflows of current financial resources. Most inflows of current financial resources are reported as *revenues.* In some specific instances, however, increases in current financial resources are reported instead as *other financing sources.*

Typically, this category has been used to isolate certain one-time inflows of current financial resources that might otherwise distort a governmental fund's regular ongoing revenue trends. GAAP provide for the use of the other financing sources category in five specific instances.

- *Issuance of debt.* The issuance of long-term debt increases a governmental fund's current financial resources. Nonetheless, including debt-related inflows among a government's regular revenues could distort a government's revenue trends. Accordingly, GAAP call for the issuance of debt to be reported separately as an other financing source. The amount so reported should equal the face value of the debt.[1] If debt is issued at a premium, the premium should be reported as a separate other financing source in its own right.[2] The GAAP treatment to record the inception of a capital lease in a governmental fund is patterned on that just described for other long-term debt. That is, an amount equal to the present value of the net minimum lease payments is reported as an other financing source, *even though no cash is actually received in the case of a lease*.[3] Conversely, the proceeds of *no-commitment* special assessment debt are considered the functional equivalent of a grant (because the government receives resources without incurring any obligation for their repayment), and should be reported as revenue, just like other grants.[4]
- *Interfund transfers.* Inflows of current financial resources from other funds are to be distinguished from a government's regular revenues. So

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[1] GASB Statement No. 34, paragraph 88 (as amended).
[2] GASB Statement No. 34, paragraph 88.
[3] National Council on Governmental Accounting (NCGA) Statement 5, *Accounting and Financial* Reporting Principles for Lease Agreements of State and Local Governments, paragraph 14.
[4] GASB Statement No. 6, *Accounting and Financial Reporting for Special Assessments*, paragraph 19. The term "proceeds" is *not* used in connection with such debt.

interfund transfers received from other funds are reported as an other financing source rather than as revenue.[5]

- *Proceeds of the sale of capital assets.* In substance, the sale of a capital asset constitutes the conversion of a non-financial economic resource (capital asset) into a current financial resource (cash). The proceeds of capital asset sales should be reported as an other financing source to avoid distorting the governmental fund's regular revenue trends.[6] Indeed, when such amounts become significant, they may need to be classified as *special items.*[7]
- *Insurance proceeds.* Insurance recoveries, if material, are properly reported in governmental funds as an other financing source if they do not meet the test for reporting as extraordinary items.[8]
- *Payments on demand bonds reported as fund liabilities.* Demand bonds are debt securities with a "put" feature that allows bondholders to demand repayment before maturity. GAAP allow demand bonds to be treated like other long-term debt, provided certain specific criteria are met. Demand bonds that do *not* meet these criteria must be reported as fund liabilities in the governmental fund that receives the proceeds. GAAP require debt service principal payments on demand bonds to be reported as expenditures in either situation. Ordinarily, however, debt service principal payments on debt reported as a fund liability would be reported simply as a balance sheet transaction (i.e., an equal decrease in the appropriate liability and cash accounts). To eliminate this difficulty, GAAP direct that an other financing source be reported in connection with debt service principal payments on demand bonds reported as governmental fund liabilities.[9]

Other financing uses

Just as governmental funds distinguish revenues from other financing sources, governmental funds also distinguish *expenditures* from *other financing uses. O*nce again, the purpose of this distinction is to avoid potential distortions in trend data. GAAP direct governments to report other financing uses in four specific instances:

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[5] GASB Statement No. 34, paragraph 88.
[6] GASB Statement No. 34, paragraph 88.
[7] GASB Statement No. 34, paragraph 56.
[8] GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, paragraph 21.

[9] Thus, the debits and credits for the repayment of the principal of demand bonds would be as follows: debits—1) demand bonds payable and 2) debt service expenditures - principal on demand bonds; credits—1) cash and 2) other financing sources - demand bond principal repayment. See GASB Interpretation No. 1, *Demand Bonds Issued by State and Local Governmental Entities (an Interpretation of NCGA Interpretation 9)*, paragraph 13.

- *Issuance discounts on long-term debt.* As already noted, GAAP require that the other financing source reported for the issuance of long-term debt be equal to the face value of the debt. However, if debt is issued at a discount (i.e., because the stated rate of interest on the debt is less than the comparable market rate of interest at the time the debt is issued), the proceeds received will be less than face value. GAAP direct that an other financing use be utilized to account for this difference. This other financing use should *not* be netted against the other financing sources reported for either the debt itself or for debt-related premiums.
- *Refunding transactions.* Governments often elect to take advantage of favorable changes in interest rates by issuing new debt to refinance existing (old) debt. Likewise, a government may elect to refinance old debt to escape onerous debt covenants. Such transactions are referred to as *refundings*. In the case of a *current* refunding, the proceeds of the refunding debt are applied immediately to redeem the old debt. In the case of an *advance* refunding, the proceeds of the refunding debt are placed into an escrow account pending the call date or maturity of the old debt. Most advance refundings result in the *defeasance* of the old debt (i.e., for accounting purposes, the debt is treated as though it had been redeemed). In the case of both current refundings and advance refundings resulting in the defeasance of debt, GAAP direct that the proceeds of the refunding bonds, whether used for redemption or placed in escrow, be reported as an other financing use rather than as an expenditure. Otherwise these significant and irregular outflows of current financial resources could substantially distort a government's regular debt service expenditure trends.
- *Interfund transfers.* The transfer of resources to another fund is clearly different in substance from the consumption of those same resources, even though both situations result in a decrease in a given governmental fund's current financial resources. Hence, transfers to other funds are reported as an other financing use rather than as an expenditure.
- *Reclassification of demand bonds as a fund liability.* As noted in the discussion of other financing sources, demand bonds may be treated as long-term liabilities, despite their "put" feature and provided they meet certain specific criteria. It is possible a demand bond that originally met these criteria might at some later time cease to do so. In that case, GAAP direct that the obligation be reclassified as a fund liability in the governmental fund that originally received the proceeds. The journal entry used to effect this reclassification would include an other financing use equal to the amount of the demand bonds henceforth to be reported as a fund liability.[10]

[10] GASB Interpretation No. 1, paragraph 13.

Special and extraordinary items

Special items are unique to financial reporting for state and local governments and are used in connection with all types of funds, as well as in conjunction with government-wide financial reporting. Special items are closely related to *extraordinary items*, which exist in the public *and* private sectors.

Extraordinary items are *both* 1) unusual in nature (possessing a high degree of abnormality *and* clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity); *and* 2) infrequent in occurrence (not reasonably expected to recur in the foreseeable future, taking into account the environment in which the entity operates). The primary factor in applying both criteria is the environment within which an entity operates. Consequently, what is "unusual in nature" or "infrequent in occurrence" for one entity may not be so for another.[11] For example, hurricane damage may qualify as an extraordinary item in the Midwest, but not in Florida.

Special items, on the other hand, are *significant items, subject to management's control,* that meet one, *but not both* of the criteria used for identifying extraordinary items. For example, a major sale of park land might be considered unusual for a government (i.e., only incidentally related to its ordinary and typical activities), even though it would not be unreasonable to expect a similar sale sometime in the future. In that case, the sale of park land, if significant, would be reported as a special item.

It is important to emphasize that special items *must be subject to management control*. Thus, natural disasters in areas prone to such disasters, although they meet one but not both of the criteria for an extraordinary item (i.e., they are unusual in nature, but not infrequent in occurrence), may *not* be classified as special items because they are *not* subject to management's control.

Special items are treated exactly like extraordinary items for financial reporting purposes (i.e., a separate line item near the bottom of the statement of activities). When a government has both extraordinary items and special items to report, both are included within a single category, but they are identified separately, with special items being reported first.[12]

As already mentioned, the *special items* category is applicable only to items that are deemed to be *significant*. The significance of a particular transaction or event can vary considerably between the fund financial statements and the government-wide financial statements. What is properly reported as a *special*

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[11] Authoritative guidance on extraordinary items is provided by Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions,* which was specifically adopted for the public sector by GASB Statement No. 34.

[12] GASB Statement No. 34, paragraph 56.

item in the one may not qualify for that same treatment in the other. Assume for example that a government sells one of its general capital assets. The general fund, under the modified accrual basis of accounting, would report the full amount of the proceeds of the sale in its statement of revenues, expenditures, and changes in fund balances. Conversely, the government-wide statement of activities, consistent with the accrual basis of accounting, would report only the gain or loss on the sale. Thus, while the proceeds of such a sale might be significant enough to qualify as a special item in the governmental fund financial statements, the related gain or loss might not be significant enough for this same classification when reported as part of governmental activities in the government-wide financial statements.[13]

Special and extraordinary items should be reported on a separate line after endowment and permanent fund contributions. If special items and extraordinary items occur in the same period, the two should be reported within a single category, with special items reported before extraordinary items.[14]

Proceeds of the sale of capital assets

In substance, the sale of a capital asset constitutes the conversion of a non-financial economic resource (capital asset) into a current financial resource (cash). The proceeds of capital asset sales should be reported as an other financing source to avoid distorting the governmental fund's regular revenue trends.[15] Indeed, when such amounts become significant, they may need to be classified as *special items.*[16]

Accrued liabilities normally financed in future periods

Governments typically liquidate their accrued liabilities with expendable available financial resources. Accordingly, an expenditure normally is recognized in a governmental fund at the same time that a liability is incurred.

Such is not the case; however, for certain long-term accrued obligations that state and local governments *in general* normally do *not* expect to liquidate with expendable available financial resources, specifically:

- compensated absences (such as vacation leave and termination payments for unused sick leave);
- claims and judgments;
- special termination benefits (special benefits offered to employees for a brief period in connection with employment termination); and
- landfill closure and postclosure care costs.

[13] GASB, Comprehensive Implementation Guide (2004), 7.309.
[14] GASB Statement No. 34, paragraph 55.
[15] GASB Statement No. 34, paragraph 88.
[16] GASB Statement No. 34, paragraph 56.

Under modified accrual accounting, expenditures and liabilities related to these obligations should be recognized in governmental funds only when they mature (*when due*). Thus, in the case of compensated absences, the only portion of the liability that would be reported in a governmental fund would be the amount of reimbursable unused vacation leave or sick leave payable to employees who had terminated their employment as of the end of the fiscal year. Likewise, a claim or judgment would only be recognized as an expenditure and a liability in a governmental fund as of the date that payment became due pursuant to the terms of a settlement agreement or court judgment. For special termination benefits, recognition would occur in a governmental fund as payments to employees who accepted the offer came due. In the case of landfill closure and postclosure costs, expenditure and liability recognition would be limited to amounts that came due each period upon receipt of goods or services used in the closing and postclosure care processes.[17]

Of course, the full amount of each of these liabilities would have to be reported in the accrual-based government-wide statement of net assets.

GAAP specifically leave open the possibility of applying this same treatment to other accrued liabilities possessing similar characteristics, but only based upon the practice of state and local governments *in general*. Thus, if state and local governments as a rule normally liquidate a given type of accrued liability with available financial resources (e.g., salaries payable), a particular government cannot avoid recognizing an expenditure and a fund liability simply by making special arrangements to liquidate the liability on a long-term basis.

Sometimes governments budget resources in advance to finance the future payment of long-term liabilities. For example, a government may elect to set aside resources as employees earn vacation leave for the eventual payment of that leave. This approach to financing future costs in no way affects the recognition of expenditures and liabilities in governmental funds, which would still report only amounts that had become due and payable upon termination.[18]

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[17] GASB Interpretation No. 6, paragraph 14.

[18] It may be difficult to accumulate resources (i.e., advance fund) in a governmental fund without having a liability to offset the accumulated resources. This potential problem can be alleviated by using an internal service fund or a pension (and other employee benefit) trust fund for compensated absences. Of course, the use of a trust fund requires a trust agreement with a party outside the financial reporting entity, such as employees.